United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1596

ORIGINAL

To be argued by Edward Labaton.

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United States Court of Appeals

For the Second Circuit.

P/S

STUART D. WECHSLER, on behalf of himself and all others similarly situated,

Plaintiff-Appellant-Appellee,

against

SOUTHEASTERN PROPERTIES, INC.,

Defendant-Appellee-Appellant,

MONARCH FUNDING CORP., ANTHONY J. DEMATTEO, WILLIAM L. MANNING, JAMES HENRY, RONALD ULLENBERG, DAVID L. BOYD, H. T. BRADDOCK, GEORGE E. McGEE III and CHALMERS K. SMITH, and HENRY McCORD, FORRESTER & RICHARDSON, EDITH COOPER, and SCHNEIDER & BARATTA,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

PLAINTIFF-APPELLANT'S BRIEF.

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Preliminary Statement.

Plaintiff appeals from so much of the order of the United States District Court for the Southern District of New York (Knapp, J.) as denied plaintiff's application for counsel fees and costs upon dismissal of this class action (345a).* Defendant Southeastern Properties,

*Numerical references followed by the letter "a" are to the Appendix.

Inc. ("Southeastern") cross-appeals from the denial of its motion seeking to hold plaintiff responsible and for its costs, including attorneys' fees.

Question Presented.

Where a class action brought under the federal securities laws and seeking rescission has been commenced and is prima facie meritorious, and where, after substantial effort on the part of plaintiff's attorneys the action becomes moot because the defendants make an offer of rescission in response to an action brought several months later by a state governmental agency, is plaintiff's counsel entitled to attorneys' fees?

The Facts.

On May 2, 1972, plaintiff commenced a class action alleging violations of §§ 11, 12(2) and 17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and §§ 352-c and 352-e of the New York General Business Law and common-law principles in connection with the public offering of 200,000 shares of common stock of Southeastern at $5 per share in January and February, 1972. The amended complaint sought rescission or damages (5a) alleging three material misstatements or omissions:

(a) The prospectus (66a *et seq.*) failed to disclose the pendency of merger negotiations between Southeastern and Apollo Industries, Inc.;

(b) The prospectus failed to disclose that filing requirements of the States of New York and New Jersey had not been complied with, as a result of which the securities sold were not freely tradable; and

(c) The assets reflected in Southeastern's financial statements in the prospectus were overstated and artificially inflated.

A motion to dismiss the complaint on the merits was fully briefed and argued and was denied in an opinion by Judge Gurfein in June, 1972 (45a). Defendants then answered denying the material allegations of the complaint (14a *et seq.*). Thereafter, plaintiff commenced discovery by interrogatories, service of notice of depositions and notice of discovery of documents.

By notice of motion and affidavit dated July 31, 1972, plaintiff moved (109a) for a class action determination returnable August 22, 1972. The motion was adjourned at the request of the defendants until October 13, 1972. In the meantime, on September 12, 1972, the Attorney General of the State of New York commenced an action in the Supreme Court of the State of New York alleging that Southeastern had violated certain provisions of Article 23A of the New York General Business Law (the Martin Act) and demanding that Southeastern refund to the investing public the $1,000,000 raised in the offering (176a). On November 21, 1972, the District Court entered a memorandum order (192a-197a) in which it deferred ruling on the class action motion because a serious question was presented as to whether the class action or the proceeding subsequently initiated by the New York Attorney General was the superior method of a fair and efficient adjudication of the controversy. A hearing was then held on December 20, 1972, in which the court was informed that, subject to certain conditions, a rescission offer would be made by Southeastern in the state court action and the court, on the consent of plaintiff's counsel (211a), deferred deciding the class action motion pending determination of the state court action and the rescission offer thereunder. A rescission offer was made

in March, 1973 (213a *et seq.*), pursuant to a consent injunction dated December 21, 1972 (228a *et seq.*). Upon the conclusion of the rescission offer, plaintiff sought interrogatories to determine the results of the offer (199a *et seq.*) and the defendant Southeastern cross-moved to dismiss the complaint with costs "including reasonable attorneys' fees on the ground that plaintiff and plaintiff's attorneys have vexatiously and without good cause multiplied the proceedings herein and have caused defendant Southeastern Properties, Inc. to incur increased costs" (244a). Other defendants also made motions to dismiss the complaint (279a, 284a, 289a). A hearing was held on July 31, 1973 (316a *et seq.*) in the course of which it was acknowledged that the offer of rescission having been accepted by more than 96% of the public stockholders, the only issue remaining was the question of whether plaintiff's counsel was entitled to attorneys' fees (330a-332a). The court in the argument suggested that a case then *sub judice* before this court (*Grace v. Ludwig*, 484 F. 2d 1262 [2d Cir. 1973]) might be helpful on the issue of counsel fees (323a) and that the district court would prefer to have this court's reasoning in *Grace* before deciding the issue of plaintiff's counsel fees (335a).

In an opinion dated April 4, 1974, this court denied plaintiff's application for counsel fees even though it found that "this action was initiated by plaintiff without knowledge and independently of—the Attorney General's investigation" and that "the pendency of this action may have made the defendant Southeastern more amenable to settle with the Attorney General * * *" (351a).

POINT I.

Plaintiff's counsel is entitled to a fee award.

Among the principal findings upon which the court based its denial of fees to plaintiff's counsel was its finding that the Attorney General acted on his own and was not influenced by plaintiff's action. The court made no determination of the merits of this action, although it assumed in the oral argument that the action had merit and, indeed, it is clear that this action was meritorious.*

The facts of this case are stark in their simplicity. The defendants in connection with a public offering of securities perpetrated a fraud upon the investing public. In March, 1972, the Attorney General of the State of New York commenced an investigation regarding the public offering. Shortly thereafter, plaintiff commenced a class action on behalf of those defrauded and pursued it diligently against tenacious defendants. Four months later, the Attorney General commenced an action in the state court based upon the same facts. The appropriate relief in the federal action brought by plaintiff was rescission. The result sought by the Attorney General was also rescission. The defendants elected to settle with the Attorney General and they claim that there is

*The specific factual allegations of fraud which followed the Attorney General's investigation appear in the affidavit of Thomas N. Dolan, sworn to September 7, 1972 (135a *et seq.*). Further, it strains credulity that Southeastern would have consented to a settlement wherein it was obliged to pay back $1,000,000 of a public offering in which it had received a net amount of less than $850,000 (71a), unless liability was clear. Finally, if there was any residuum of doubt as to liability, plaintiff's counsel offered to prove defendants' culpability under the amended complaint (330a).

no obligation to plaintiff or to counsel for the fees incurred in connection with the prosecution of this action.

A recent decision of the Supreme Court of Delaware in a stockholders derivative action is, we submit, directly in point and should be controlling in this case. In *McDonnell Douglas Corporation v. David Palley* (Del. Supr., 310 Atl. 2d 635 [1973]), plaintiff applied for an allowance of counsel fees after the suit became moot by reason of subsequent action taken by the corporation on whose behalf the action was brought. The court held that the award of counsel fees was proper, stating that

> "where a stockholder's derivative suit has been rendered moot by a subsequent action of the defendant the latter has the burden of showing no causal connection between the two in order to defeat the stockholder's claim for legal fees and expenses" (p. 637).

Here, the causal connection is established by (1) the validity of the complaint as determined by Judge Gurfein's decision; (2) the capitulation of Southeastern to the Attorney General; and (3) the district court's finding that the pendency of this action may have made Southeastern more amenable to settle with the Attorney General. In *McDonnell Douglas*, the Delaware court cited with approval an earlier decision of that court, *Chrysler Corporation v. Dann* (Del. Supr., 223 Atl. 2d 384 [1966]), in which the court held:

> To justify an allowance of fees the action in which they are sought must have had merit at the time it was filed.

and that

> A claim is meritorious within the meaning of the rule if it can withstand a motion to dismiss

> on the pleadings if, at the same time, the plaintiff possesses knowledge or provable facts which hold out some reasonable likelihood of ultimate success. It is not necessary that factually there be absolute assurance of ultimate success, but only that there be some reasonable hope.

Defendants' self-serving conclusion that its settlement with the Attorney General had nothing to do with the commencement of this action is inconsistent with its counsel's statement on the record below (333a) that on the basis of a case he had litigated in the state court it was doubtful that the Attorney General could obtain full rescission. In that case (*Atkin v. Hill, Darlington & Grimm*, 23 A. D. 2d 331, 260 N. Y. S. 2d 482, aff'd 18 N. Y. 2d 980), the court held that a violation of §51(6) of the New York Insurance Law (which prohibits a public offering of unlicensed foreign insurance companies) did not automatically warrant rescission. There is no comparable ambiguity as to the appropriateness of rescission as a remedy where the feedral securities laws are violated (see §12 of the Securities Act of 1933, 15 U. S. C. §77-1; *Myzel v. Fields*, 386 F. 2d 718, 741 [8th Cir. 1967], cert. denied 390 U. S. 951; 6 Loss Securities Regulation 1793; Bromberg Securities Law—Fraud SEC Rule 10b-5; §§ 9.1, 9.2).

In *Mintz v. Bohen* (Del. Ch., 210 Atl. 2d 569 [1965]), Chancellor Seitz, denying the defendant's motion for summary judgment and allowing the plaintiff to seek fees in a derivative action that was mooted, held:

> * * * I conclude that, at least in a derivative action, the plaintiff may not be deprived of counsel fees by action taken by one or more of the defendants which has the effect of curing the alleged wrong to the corporation's benefit and rendering the controversy moot, unless it be demon-

> strated that the curing of the defect is in nowise related to the lawsuit and the lawsuit would not have succeeded in any event (p. 570).

Southeastern has shown nothing of the sort.

The Delaware cases cited above fall within the general principles outlined in *Sprague v. Ticonic National Bank*, 307 U. S. 161 (1939), in which the court reviewed the equitable principles authorizing a court to allow attorneys' fees to a party as justice may require. In the *Sprague* case, the court indicated that a party could be allowed attorneys' fees even though she did not bring an action as representative of a class nor did she automatically establish a fund in which others could participate. Instead, as a consequence of *stare decisis*, the petitioner, by establishing her claim, necessarily established the claims of others. This court, in *U. S. v. American Society of Composers, Authors and Publishers*, 466 F. 2d 917 (2d Cir. 1972), relying upon *Sprague*, allowed a counsel fee, even though the attorneys did not contribute to the creation of the fund in question. Here, although plaintiff did not create the fund, the court found that this action may have influenced Southeastern in compelling it to settle with the Attorney General. That contribution by itself would warrant an allowance to plaintiff's counsel under the principles set forth above.

Some of the authorities relied upon by Judge Knapp, upon analysis, support the plaintiff. Thus, in *Grace v. Ludwig*, 484 F. 2d 1262 (2d Cir. 1973), cert. denied 40 L. Ed 2d 110, the court set forth a principle which we submit is applicable here:

> At the heart of the doctrine favoring the awarding of counsel fees in securities cases is the need to encourage the vigilance of private attorneys general to provide corporate therapy protecting

> the public investor who might otherwise be victimized * * * The need for private enforcement continues and is accented as the filings burgeon.
>
> The same policy underlies the holdings of this court in leading cases such as *Smolowe v. Delendo Corp.*, 136 F. 2d 231 (2d Cir.), cert. denied, 320 U. S. 751 (1943), *Gilson v. Chock Full O'Nuts Corp.*, 331 F. 2d 107 (2d Cir. 1964) (*en banc*), and *Blau v. Rayette-Faberge, Inc.*, 389 F. 2d 469 (2d Cir. 1968), which permitted the recovery of attorney's fees where a derivative action had been brought to recover or to instigate the recovery of insider short swing profits under section 16(b) which the corporation had failed or refused to bring on its own behalf. As we pointed out in *Smolowe*, 'the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of §16(b) * * *' 136 F. 2d at 241 (484 F. 2d at 1267-1268).

The cases which reiterate this policy are legion (see, e. g., *Mills v. Electric Auto-Lite Co.*, 396 U. S. 375; *J. I. Case Co. v. Borak*, 377 U. S. 426 at 432-433; *Dolgow v. Anderson*, 43 F. R. D. 472 at 494).

The Securities and Exchange Commission has recognized the "salutary effect which (class action) litigation has on the financial community's respect for the federal securities laws," Committee Report, Class Actions—Recommendations Regarding Absent Class Members and Proposed Opt-In Requirements, 28 Record of the Association of the Bar of the City of New York, 897, 910 (f. n. 9) (1973). The possibility of recovering attorneys' fees generally provides the sole stimulus for the commencement and prosecution of such class actions. See *Schlesinger v. Wallace*, C. C. H. Fed. Sec. L. Rep. ¶94,098 pages 94,423-5 (N. D. Ala. Apr. 16, 1973). Even in those cases where fees are denied in a class or derivative action, the rationale clearly supports an award of fees in situations similar to those at bar.

Grace v. Ludwig, supra, involved an application for a fee based upon counsel's participation in an administrative proceeding before the Securities and Exchange Commission in which counsel on behalf of its client intervened.

The court denied the application for the fee on three grounds, none of which is applicable here:

1. In *Grace* there was no need for encouraging private enforcement because the Securities and Exchange Commission had a special responsibility to issue an order for examination under §17(b) of the Investment Company Act only after it had found that the consideration was reasonable and fair and did not involve overreaching and was consistent with the policy of the Investment Company Act (484 F. 2d at 1268). Here, there was no comparable responsibility by the SEC under the federal securities laws.

2. The law firm applying for fees represented clients who had a direct and substantial interest for which they paid their counsel more than $150,000 in fees and expenses. The court found that the attorneys' representation "was not stimulated solely by the expectation of fees from those who had retained them" (484 F. 2d at 1268). Here, plaintiff's loss was small and the attorneys' representation was stimulated by the expectation of fees upon a successful conclusion of the case.

3. The award of fees on the basis of intervention in an administrative proceeding would establish a precedent which would encourage intervention in comparable cases before administrative agencies. Here, there was no intervention or attempted intervention in the administrative proceeding. Rather, a class action under the

federal securities law was commenced long before any action was commenced by any administrative agency.

In *Gilson v. Chock Full O' Nuts Corporation* (331 F. 2d 107) (2d Cir. 1964), which was cited approvingly in *Grace*, the Court of Appeals directed that the attorney be awarded a fee where he had drafted but never filed a complaint under §16(b) of the Securities Exchange Act of 1934. The corporation commenced the action independently, prior to the filing. In directing that a fee be awarded the court stated:

> "It would run counter to effective enforcement of the statute wholly to deny compensation in such a case" (331 F. 2d at 110).

It is difficult to imagine how the District Court could rely on *Gilson* and *Grace* (which while denying fees in a particular fact situation relies, generally on *Gilson*), when plaintiff at bar (a) actively litigated this case and withstood a motion to dismiss the complaint, (b) commenced discovery by way of written interrogatories, notices of deposition and production of documents, (c) and moved to determine the action to be a class action.

Another case cited with approval in *Grace* and applicable here is *Stolberg v. Members of the Board of Trustees for the State Colleges of the State of Connecticut, et al.*, 474 F. 2d 485 (2d Cir. 1973). *Stolberg* involved an action under the Civil Rights Act to sustain rights under the First Amendment. The court awarded counsel fees:

> * * * to assure that the plaintiff, and others who might similarly be forced to great expense to vindicate clear constitutional claims, are not deterred from securing such vindication by the prospect of costly, protracted proceedings which have become necessary only because of the obdurate conduct of the defendants (p. 490).

In this case, it is clear that there was almost certainly a violation of the Securities Act of 1933 and the Securities Exchange Act of 1934. In March, defendants were advised by the Attorney General of their violation of the Martin Act (267a). They had more than a month prior to the commencement of this action to announce a rescission offer, but they did not do so. Even after commencement of this action, plaintiff's counsel's efforts would have been unnecessary had the defendants at the inception of the litigation acknowledged their liability and made an offer of rescission promptly upon the assertion of the claim. Instead, they interposed answers denying the material allegations of the complaint—after a motion to dismiss was denied. It was not until sometime after the Attorney General commenced his action in September, 1972, that the rescission offer was made. Thus, the same policy reasons that justified the award of a fee in *Stolberg* require the award of a fee here.

Even if the Attorney General had commenced his action first, a private class action would have been appropriate. Thus, after the Securities Exchange Commission commenced its action against Texas Gulf Sulphur Company (see 401 F. 2d 833, 2d Cir. 1968), many civil actions were commence, prosecuted and settled. (For example, *Cannon v. Texas Gulf Sulphur*, 55 F. R. D. 308, S. D. N. Y. 1972). See also *City of Detroit v. Grinnell Corp.*, CCH Trade Reg. ¶74,986 (2d Cir., March 13, 1974), in which private actions were based upon allegations first made by a governmental agency. *United States v. Grinnell Corp.*, 236 F. Supp. 244 (D. R. I. 1964). Further, in *Grace*, where attorneys intervened in an administrative proceeding, the court noted:

> "Had the SEC granted the exemption and the initial $275 offer been approved and had LLB (the intervening attorneys) then successfully ap-

peared in a derivative action on behalf of the public stockholders, we would have a decidedly different situation" (484 F. 2d at 1269).

Here, plaintiff commenced a meritorious action long before the Attorney General's suit was commenced. It was not known for quite some time whether rescission would result from the Attorney General's action. But since rescission is a federal remedy, it is logical to assume that Southeastern's settlement was based in part on its fear of facing plaintiff's suit. Plaintiff discovered the fraud, pursued the wrongdoer and the fact that the wrongdoer sought sanctuary in the office of the Attorney General does not diminish plaintiff's efforts or entitlement to reward. This incentive has been repeatedly viewed as essential in the field of securities regulation. To deny fees to plaintiff here would be without reason, without cause, and contrary to accepted principles of law.

Several of the cases cited by the court below are too broad to be controlling here or actually support plaintiff's claim. In *Mills v. Electric Auto-Lite* (396 U. S. 375), the Supreme Court held, *inter alia*, that where the petitioners have established a violation of the securities laws by their corporation and its officials, they should be reimbursed by the corporation even if the suit never produced a monetary recovery (396 U. S. at 392). *Fleischman Distilling Corp. v. Maier Brewing Co.* (386 U. S. 714) is patently inapposite. There the Supreme Court was confronted with the Lanham Act (Sec. 35, 60 Stat. 427, 439, 15 U. S. C. Secs. 1051-1127) which was held to preclude attorney's fees in a suit for trademark infringement. Congress in passing the Lanham Act "meticulously detailed the remedies available to a plaintiff who proves that his valid trademark has been infringed" (386 U. S. at 719, 721). The court in *Fleischman* concluded that the express remedial pro-

visions were intended "to mark the boundaries of the power to award monetary relief in cases arising under the Act" (386 U. S. 719, 721). In referring to *Fleischman,* the *Mills* court stated that the remedial provisions of the Lanham Act were expressly limited by the statute. "By contrast, we cannot fairly infer from the Securities Exchange Act of 1934, a purpose to circumscribe the court's power to grant appropriate remedies." (396 U. S. at 391.) Neither of these cases deals with the much narrower issue of whether fees ought to be awarded where plaintiff's suit is rendered moot by subsequent action either independently undertaken by the corporation or by some administrative agency.

Blau v. Rayette-Faberge, Inc. (389 F. 2d 469), is readily distinguishable. There, counsel fees were denied as the attorney for the stockholder did no more than "find a claim" which the corporation then successfully brought at the stockholder's request. But even where the attorney's work was little more than investigative, the *Blau* court refused to foreclose any recovery:

> Reimbursement for information leading to corporate recovery will be allowed only if the corporation has done nothing for a substantial period of time after the suspect transactions and its inaction is likely to continue (389 F. 2d at 473).

City of Detroit v. Grinnell Corp., supra, supports plaintiff's position here. In that case, a settlement fund of $10,000,000 was created and out of which fund the district court awarded over $1.5 million to counsel who had helped arrange the agreement. This court approved the settlement but reversed and remanded as to the fee because the lower court had "displayed too much reliance upon the contingent fee syndrome" (¶74,986, at p. 96,374). The court said that, where an action had been settled, the only basis for awarding an attorney's fee is the

equitable fund theory doctrine. It went on to say that "In its simplest terms, the purpose of the fee award is to 'compensate the attorney for the reasonable value of services benefiting the * * * claimant.' *Lindy Brothers Builders, Inc., v. American Radiator and Sanitary Corporation*, 487 F. 2d 161 at 167" (CCH Trade Reg. at p. 96,375). As discussed above, the nexus between plaintiff's suit and the corporation's settlement with the class has been amply shown.

The *City of Detroit* case emphasized time as the "starting point of every fee award, once it is recognized that the court's role in equity is to provide just compensation for the attorney's services in terms of the time he has expended on the case" (at p. 96,376). Here, at the very least, the equities clearly demand reasonable compensation to plaintiff's counsel. Yet, the court denied any compensation for the time expended merely because the culpable defendant elected to moot the case by settling the Attorney General's claim. Surely, if time is to be the key factor, plaintiff's counsel's time in a case such as this should be adequately compensated.

POINT II.

The cross-appeal is patently frivolous.

In its cross-appeal, Southeastern seeks to tax plaintiff with its costs and attorneys' fees. The basis of this appeal is presumably the motion to dismiss made by Southeastern on July 11, 1973 (243a), and the accompanying affidavit of Arnold I. Burns, Esq., sworn to on July 12, 1973 (246a *et seq.*). In his opinion, Judge Knapp summarily disposed of this motion, stating:

> While both plaintiff's attorney and defendant Southeastern have applied to this court for attorneys' fees and costs, the only real issue before the court is whether such costs should be awarded to plaintiff's counsel. Defendant Southeastern has charged the plaintiff has unduly harassed it, but such argument appears invalid from the record before the court and thus provides no basis for awarding defendant costs (350a).

Southeastern's claim to costs and counsel fees was indeed frivolous and was not entitled to serious consideration by the court below. The plaintiff in this case did nothing to interfere with the Attorney General's action or with the proceeding in the state court. Rather the plaintiff prosecuted this action diligently to protect his interest and the interest of the class. Southeastern's contention that plaintiff's action was redundant is demolished by the district court's finding that as late as November 21, 1972, "that no firm offer of rescission [had] been made" (195a). When it appeared that a firm offer of rescission would be made, plaintiff's counsel consented to deferring a decision on the class action motion (211a) and when it appeared that the rescisson offer had been accepted by the vast majority of Southeastern's stockholders, plaintiff offered no objection to the dismissal of the class action (317a). The critical fact overlooked by Southeastern in making its motion is that, up through the making of the class action motion, plaintiff and its counsel were entitled to believe (a) that Southeastern would not make a rescission offer (299a); (b) that it was actively engaged in using the public's money in conducting its business (297a-299a); and (c) that unless plaintiff proceeded with the prosecution of this action there was a danger that Southeastern's assets (including the cash derived from the public) would be dissipated. Defendant's motion made much of the fact that plaintiff's counsel communicated with the district court and, at the sug-

gestion of Judge Knapp, with the New York State Supreme Court in connection with the rescission offer. The correspondence is reflected at 232a-236a. We are frankly baffled by Southeastern's complaint regarding these communications. We submit that plaintiff and his counsel had every right to communicate with the court as to the procedures of the rescission offer and also had the right to request information from the company that had defrauded plaintiff and the class that he represented.

Conclusion.

Plaintiff in good faith commenced a meritorious class action based upon serious violations of the federal securities laws. The action was made moot by the settlement of an action subsequently brought by the New York State Attorney General.

Counsel fees should be awarded plaintiff for the services rendered.

Respectfully submitted,

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